IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

THE WINER FAMILY TRUST	:	CIVIL ACTION
	:	
v.	:	
	:	
MICHAEL QUEEN, et al.	:	NO. 03-4318

MEMORANDUM

Padova, J. **January 13, 2005**

Presently before the Court in this securities class action is The Winer Family Trust's Motion for Leave to Amend and File a Second Amended Complaint. As granting leave to amend would be futile in this case, the Motion is denied in its entirety.

I. BACKGROUND

On July 24, 2003, The Winer Family Trust (hereinafter, "Lead Plaintiff") commenced this securities class action by filing a 38-page, 80-paragraph Complaint against Pennexx Foods, Inc. ("Pennexx"), Smithfield Foods, Inc. ("Smithfield"), and several officers and directors of those corporations. Lead Plaintiff's original Complaint alleged violations of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), as amended by the Private Securities Litigation Reform Act of 1995 ("PSLRA"), 15 U.S.C. §§ 78j(b), 78t(a), and Rule 10b-5 promulgated thereunder, see 17 C.F.R. § 240.10b-5, as well as violations of Section 20(a) of the Exchange Act. The original Complaint also alleged a state law claim for breach of fiduciary duty.

On November 6, 2003, the Court held a case management

conference. After the conference, the Court entered an Order requiring Defendants to "submit to [Lead Plaintiff], in writing, a list of any and all perceived deficiencies in the Complaint within seven (7) days." (Nov. 7, 2003 Order.) Pursuant to the Court's Order, the Smithfield Defendants and Pennexx Defendants each timely sent Lead Plaintiff's counsel a detailed letter outlining the "perceived deficiencies" in the Complaint. (Smithfield Defs.' Mem. at 2-3; Smithfield Defs.' Ex. 1.) On November 19, 2003, the Court entered a Case Management Order that had been jointly submitted by the parties. The Case Management Order permitted Lead Plaintiff to file an amended complaint on or before December 22, 2003.

On December 22, 2003, Lead Plaintiff filed a 96-page, 222-paragraph First Amended Complaint ("FAC") on behalf of two separate classes. On behalf of public investors who purchased Pennexx securities during the period from February 8, 2002 until June 12, 2003 (hereinafter, "the Securities Class"), Lead Plaintiff alleged Rule 10b-5 claims against Pennexx; Joseph W. Luter IV, executive Vice President of Smithfield and former Pennexx director; Michael H. Cole, associate general counsel of Smithfield and former Pennexx director; Michael Queen, Chief Executive Officer of Pennexx and Pennexx director; and Thomas McGreal, Vice President of Sales for Pennexx and Pennexx director. On behalf of the Securities Class, Lead Plaintiff also alleged Section 20(a) claims against Smithfield and the individual Defendants. On behalf of public investors who

currently own Pennexx securities (hereinafter, "the Fiduciary Class"), Lead Plaintiff asserted state law claims for breach of fiduciary duty against Queen; breach of fiduciary duty against Smithfield; aiding and abetting Smithfield's breach of fiduciary duty against Luter and Cole; and successor liability against Smithfield and Showcase Foods, Inc. ("Showcase").

On January 21, 2004, the Pennexx Defendants (Pennexx, Queen, and McGreal) and the Smithfield Defendants (Smithfield, Showcase, Luter, and Cole) each filed Motions to Dismiss the FAC pursuant to Federal Rule of Civil Procedure 12(b)(6). On February 20, 2004, Lead Plaintiff's filed a response in opposition to the Motions to Dismiss. On April 7, 2004, after the Motions were fully briefed, the Court heard oral argument on the Motions. At the conclusion of the hearing, the Court requested that Lead Plaintiff file a supplemental submission which distilled the 96-page FAC into a comprehensive chart outlining each of Lead Plaintiff's Rule 10b-5 claims. (4/7/04 Tr. at 79-81.) Lead Plaintiff submitted the requested chart on April 27, 2004, and the Pennexx Defendants and the Smithfield Defendants thereafter filed a joint response on May 11, 2004.

On June 21, 2004, counsel for the Smithfield Defendants informed Lead Plaintiff and the Pennexx Defendants that Showcase, a subsidiary of Smithfield, intended to shut down operations at its facility on Tabor Road in Philadelphia (hereinafter, "the Tabor

Facility") and to remove certain equipment from the facility.[1] On June 30, 2004, while the Motions to Dismiss were still pending before the Court, Lead Plaintiff filed a motion to conduct limited discovery related to the Tabor Facility, asserting that "a key component of the claims of the proposed class is the nature and extent to which the Smithfield [D]efendants mis-designed and undermined construction and production at the Tabor Facility and the extent to which disclosures by the Pennexx and Smithfield Defendants related to the suitability, efficiency, and production capacity of the Tabor Facility were false and misleading." (Pl.'s Mem. at 1.) On July 15, 2004, the Court entered an Order requiring the Smithfield Defendants to provide Lead Plaintiff with "documents related to the design plans, construction, renovation, equipment, and functioning of the Tabor Facility" and to allow Lead Plaintiff two days to copy and inspect the documents. (July 15, 2004 Order.) Pursuant to the July 15, 2004 Order, Lead Plaintiff was also permitted to depose Donald Countryman, Pennexx's former Vice President of Quality Control, and Smithfield's corporate designees under Federal Rule of Civil Procedure 30(b)(6), on the following topics: "the design plans, construction, renovation, equipment[,]

[1] The Tabor Facility was owned and operated by Pennexx during the Securities Class period. As a result of defaults under its credit agreement with Smithfield, Pennexx executed a deed in lieu of foreclosure to the Tabor Facility on June 11, 2003. (Am. Coml. ¶ 160.) At the request of Smithfield, the deed was delivered to Showcase. (Id.)

functioning and deficiencies of the Tabor Facility; disputes between Pennexx and Smithfield regarding the design, construction, equipment, renovation, functioning and deficiencies of the Tabor Facility; and identification by Pennexx and Smithfield of design, equipment and operational problems and/or deficiencies of the Tabor Facility." (Id.) Lead Plaintiff and the Pennexx Defendants were further permitted to inspect the Tabor Facility on or before July 23, 2004, the date by which the Court required all of the authorized discovery be completed. (Id.)

On September 27, 2004, the Court issued a Memorandum and Order granting in part and denying in part Defendants' Motions to Dismiss the FAC. See Winer Family Trust v. Queen, Civ. A. No. 03-4318, 2004 WL 2203709 (E.D. Pa. Sept. 27, 2004). The Court granted Defendants' Motions to Dismiss with respect to the Rule 10b-5 claims, except as to the claims against Pennexx based on the challenged statements and omissions from Pennexx's August 14, 2002, January 30, 2003, and the March 31, 2003 press releases, and the claims against Queen based on the challenged statements and omissions from Pennexx's January 30, 2003 and March 31, 2003 press releases.[2] Id. at *26 & n.18. The August 14, 2002 press release

[2] The Court also granted the Pennexx Defendants' Motion to Dismiss with respect to the breach of fiduciary duty claim against Queen and the Smithfield Defendants' Motion to Dismiss with respect to the breach of fiduciary claims against Smithfield, Cole and Luter. Id. at *26. The Court denied Defendants' Motions to Dismiss with respect to the Section 20(a) claims against Smithfield, Luter, Queen, McGreal, and Cole, as well as the

relates to the departure of George Pearcy, Pennexx's former Chief Financial Officer, and the January 30, 2003 and March 31, 2003 press releases relate to the Tabor Facility renovations.

On October 6, 2004, the Court held another case management conference. At the conference, Lead Plaintiff advised the Court that it wanted to file a second amended complaint in order to replead its Rule 10b-5 claims based on "new information which would show that statements earlier on in the original class period should remain in the case." (10/6/04 Tr. at 31.) After the Smithfield Defendants raised an objection to Lead Plaintiff's filing of a second amended complaint, the Court instructed Lead Plaintiff to file a motion for leave to file a second amended complaint. Lead Plaintiff thereafter filed the instant Motion for Leave to Amend and File a Second Amended Complaint. The proposed Second Amended Complaint ("SAC") is attached as an exhibit to the instant Motion. The instant Motion has been fully briefed by the parties and is ripe for decision.

II. LEGAL STANDARD

Federal Rule of Civil Procedure 15(a) provides that a party may amend its pleading after a responsive pleading is served only by leave of the court and "when justice so requires." Fed. R. Civ. P. 15(a). Although Rule 15(a) states that leave should be "freely

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Smithfield Defendants' Motion to Dismiss with respect to the successor liability claim against Smithfield and Showcase. Id.

given," id., the United States Court of Appeals for the Third Circuit ("Third Circuit") has held that "a District Court may deny leave to amend on the grounds that amendment would cause undue delay or prejudice, or that amendment would be futile." In re Alpharma Inc. Sec. Litig., 372 F.3d 137, 153 (3d Cir. 2004) (quoting Oran v. Stafford, 226 F.3d 275, 291 (3d Cir. 2000)). The decision whether to grant or deny a motion for leave to amend a complaint is committed to the sound discretion of the district court. Cureton v. Nat'l Collegiate Athletic Ass'n., 252 F.3d 267, 272 (3d Cir. 2001).

III. DISCUSSION

The SAC alleges both new and modified Rule 10b-5 claims against Pennexx, Queen, McGreal, Luter, and Cole. Defendants argue that leave to file the SAC should be denied on the basis of (1) undue delay and prejudice, and (2) futility. The Smithfield Defendants also request that the Court order Lead Plaintiff to reimburse them for the costs of responding to the instant Motion.

A. Undue Delay and Prejudice

Defendants argue that leave to amend should be denied because Lead Plaintiff unduly delayed in filing the instant Motion, resulting in prejudice to Defendants. Delay alone is an insufficient ground to deny leave to amend. Adams v. Gould Inc., 739 F.2d 858, 868 (3d Cir. 1984). However, "at some point, the delay will become 'undue,' placing an unwarranted burden on the

court, or will become 'prejudicial,' placing an unfair burden on the opposing party." Id. "The obligation of the district court in its disposition of the motion is to articulate the imposition or prejudice caused by the delay, and to balance those concerns against the reasons for delay." Coventry v. U.S. Steel Corp., 856 F.2d 514, 520 (3d Cir. 1988). Prejudice in the context of Rule 15(a) means "undue difficulty in prosecuting [or defending] a lawsuit as a result of a change in tactics or theories on the part of the other party." In re Aetna Inc., Civ. A. No. 1219, 2000 WL 3211286, at *1 (E.D. Pa. Mar. 17, 2000) (quoting Deakyne v. Comm'rs of Lewes, 416 F.2d 290, 300 (3d Cir. 1969)).

Defendants note that Lead Plaintiff obtained the information which forms the basis of the new allegations in the SAC from the limited discovery that the Court permitted during July 2004. Instead of promptly seeking amendment while Defendants' Motions to Dismiss the FAC were still pending before this Court, however, Lead Plaintiff elected to stand firm on the sufficiency of the FAC until the Court issued its September 27, 2004 ruling. Thereafter, Lead Plaintiff promptly filed the instant Motion, in part to "cure deficiencies" in the Amended Complaint, (see Pl. Mem. at 1), as outlined in the Court's decision, even though these deficiencies were previously identified by Defendants in letters to Lead Plaintiff's counsel, as well as in several submissions filed in connection with the Motions to Dismiss. Defendants maintain that

granting Lead Plaintiff leave to file the SAC will cause them to incur additional costs and expenses and will further delay the resolution of this action. Defendants also note that Lead Plaintiff has already had numerous opportunities to plead its case. In response, Lead Plaintiff concedes that the new allegations made in the SAC are based solely on discovery conducted in mid-July 2004, (Pl.'s Mem. at 10-11), yet offers no explanation as to why it waited over two months until the Court issued its decision on the Motions to Dismiss the FAC to seek amendment.

Although the Court does not condone the apparent "wait-and-see-what-happens" approach taken by Lead Plaintiff in this case,[3]

[3] The Court notes that at least one other district court has denied a motion for leave to amend a securities class action complaint under similar circumstances. In In re Stone & Webster, Inc. Sec. Litig., 217 F.R.D. 96 (D. Mass. 2003), the securities plaintiffs moved for leave to file a 148-page, 450-paragraph second amended complaint after the court had dismissed most of the securities claims asserted in the first amended complaint. Id. at 97. The plaintiffs maintained that the second amended complaint would "remedy all of the defects" identified in the court's decision on the motion to dismiss. Id. The plaintiffs conceded that much of the information that they incorporated in the proposed second amended complaint was, in fact, available to them during the pendency of the motions to dismiss the first amended complaint. Id. at 98. In denying the motion for leave to the file the second amended complaint on the basis of undue delay, the court stated as follows:

> The fact that the plaintiffs chose to oppose the motions to dismiss on the grounds that their complaint was, in their view, sufficiently pleaded, rather than providing the additional information known to them during the necessarily lengthy period during which the motions to dismiss were being considered, smacks of gamemanship bordering on bad faith. A plaintiff shouldering the burden

the Court cannot conclude that Lead Plaintiff's delay in filing the instant Motion is sufficiently undue or prejudicial to justify the denial of leave to amend at this juncture. The new allegations in the SAC relate to and integrate with the allegations in the FAC. Thus, the proposed SAC does not reflect a change in tactics or theories by Lead Plaintiff such that Defendants will be forced to substantially revise their present defense strategy. Accordingly, under the present circumstances of this case, the Court declines to deny the instant Motion on the grounds of undue or prejudicial delay.

> of pleading under the PSLRA cannot pull its punches in this way and then expect a district court to allow that plaintiff another chance once the matter has not only been fully briefed, but actually decided. Considerable effort of the parties and the court was expended in deciding the motion to dismiss: the papers of the parties in support of and in opposition to the motion, the relevant documents at issue, and the pertinent cases created a veritable mountain of documents – a mountain that I laboriously climbed more than once . . . When a plaintiff fails to seek leave to amend after a motion to dismiss has been filed, and is aware of the stringent pleading requirements [of the PSLRA], the logical inference is that the plaintiff intends to stand on his or her complaint. To hold back facts the plaintiffs now characterize as helpful or even crucial to their case . . . strikes me as precisely the sort of 'undue delay' that should result in a denial of leave to amend.

Id. at 98-99 (internal citations omitted).

B. Futility

Defendants also argue that leave to amend should be denied on the grounds that the amendment would be futile. "Futility means that the complaint, as amended, would fail to state a claim upon which relief could be granted." In re Alpharma, 372 F.3d at 153; see also In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1435 n.22 (3d Cir. 1997) (instructing district court to perform futility inquiry when securities plaintiff tenders proposed amendments to complaint). Thus, futility is governed by the same standard of legal sufficiency as applies under Federal Rule of Civil Procedure 12(b)(6). Id. at 153-54. When determining a motion to dismiss pursuant to Rule 12(b)(6), the court must accept as true all well pleaded allegations in the complaint and view them in the light most favorable to the plaintiff. Angelastro v. Prudential-Bache Securities, Inc., 764 F.2d 939, 944 (3d Cir. 1985). A Rule 12(b)(6) motion will be granted when a plaintiff cannot prove any set of facts, consistent with the complaint, which would entitle him or her to relief. Ransom v. Marrazzo, 848 F.2d 398, 401 (3d Cir. 1988). Documents "integral to or explicitly relied upon in the complaint" and related matters of public record may be considered on a motion to dismiss. In re Burlington Coat Factory, 114 F.3d at 1426 (emphasis omitted).

To state a Rule 10b-5 claim, a plaintiff must allege that the defendant (1) made a misstatement or an omission of a material

fact; (2) with scienter; (3) in connection with the purchase or the sale of a security; (4) upon which the plaintiff reasonably relied; and (5) that plaintiff's reliance was the proximate cause of his or her injury. In re IKON Office Solutions, Inc., 277 F.3d 658, 666 (3d Cir. 2002). Defendants primarily argue that the proposed amendments fail to adequately allege that any of the Defendants made a misstatement or omission of material fact with scienter.

The scienter element of a Rule 10b-5 claim requires a complaint to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind" with respect to each act or omission alleged to violate the securities laws. 15 U.S.C. § 78u-4(b)(2). The Third Circuit has defined "scienter" as "a mental state embracing an intent to deceive, manipulate or defraud, or, at a minimum, highly unreasonable (conduct), involving not merely simple, or even excusable negligence, but an extreme departure from the standards of ordinary care, . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." In re Alpharma, 372 F.3d at 148 (quoting In re IKON, 277 F.3d at 667). Scienter may be established "either (a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial

evidence of conscious misbehavior or recklessness."[4] In re Burlington Coat Factory, 114 F.3d at 1417. To support the requisite "strong inference" of scienter,

> a plaintiff must state facts that, if true, would compel or forcefully suggest that a given defendant acted with the required state of mind. A plaintiff need not disprove every conceivable rationale a defendant might put forward to explain why a particular statement was made. However, if the facts alleged do not exclude other plausible explanations that would undercut a plaintiff's circumstantial evidence of scienter, then that plaintiff's facts cannot be fairly said to raise a 'strong inference' that the defendant acted with the required state of mind.

Nappier v. Pricewaterhouse Coopers LLP, 227 F. Supp. 2d 263, 278 (D.N.J. 2002) (citation omitted); see also In re Alpharma, 372 F.3d at 150 ("Indeed, while under Rule 12(b)(6) all inferences must be drawn in plaintiffs' favor, inferences of scienter do not survive if they are merely reasonable . . . Rather, inferences of scienter survive a motion to dismiss only if they are both reasonable and 'strong' inferences.") (citation omitted); In re Digital Island

[4] Lead Plaintiff does not attempt to plead scienter by alleging facts that show that Defendants had both motive and opportunity to commit fraud. The Court's scienter analysis is, therefore, confined to whether the SAC sufficiently alleges facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness by Defendants. See GSC Partners CDO Fund v. Washington, 368 F.3d 228, 238 (3d Cir. 2004) ("Where motive is not apparent, it is still possible to plead scienter by identifying circumstances indicating conscious behavior by the defendant, though the strength of the circumstantial allegations must be correspondingly greater.") (quoting Kalnit v. Eichler, 264 F.3d 131, 142 (2d Cir. 2001)).

Sec. Litig., 357 F.3d 322, 328 (3d Cir. 2004) ("In requiring a 'strong inference' of scienter, the PSLRA alters the normal operation of inferences under Fed. R. Civ. P. 12(b)(6)."). Leave to amend is properly denied as futile where the proposed amendments fail to allege facts that give rise to a strong inference of scienter. In re Alpharma, 372 F.3d at 154.[5]

Plaintiffs' 10b-5 claims in the proposed SAC are based on allegedly false or misleading statements contained in several press releases issued by Pennexx and in several reports that Pennexx

[5] In addition to "stating with particularity facts giving rise to a strong inference of scienter," 15 U.S.C. § 78u-4(b)(2), the PSLRA requires securities plaintiffs to "specify each statement alleged to have been misleading" and "the reason or reasons why the statement is misleading." 15 U.S.C. § 78u-4(b)(1). Moreover, where, as in this case, the allegations regarding the statement or omission are made on information and belief, "the complaint shall state with particularity all facts on which that belief is formed." Id. Federal Rule of Civil Procedure 9(b) also requires plaintiffs asserting securities fraud claims to specify "the who, what, when, where, and how: the first paragraph in any newspaper story." In re Advanta Corp. Sec. Litig., 180 F.3d 525, 534 (3d Cir. 1999) (citation omitted). In their opposition filings, Defendants do not specifically argue that the allegations of the SAC are insufficiently particularized under the PSLRA and Rule 9(b). In light of the Third Circuit's recent pronouncements on the stringency of these threshold pleading requirements, see Cal. Public Employees' Retirement System v. Chubb Corp., --- F.3d ---, 2004 WL 3015578 (3d Cir. Dec. 30, 2004), it appears to the Court that at least some allegations of the SAC are insufficiently particularized. For the sake of argument, however, the Court assumes that, with the exception of the group pleading allegations (see note 6, *infra*), all of the allegations of the SAC are sufficiently particularized under the PSLRA and Rule 9(b). Accordingly, the Court's inquiry is limited to whether the particularized allegations of the SAC sufficiently establish misstatements of material fact and give rise to a strong inference that Defendants acted with scienter in making the challenged misstatements.

filed with the United States Securities and Exchange Commission ("SEC") during the class period.[6] The subject matter of the alleged misstatements falls into three general categories: (1) the initial condition of, and the cost of renovations to, Pennexx's Tabor Road Facility ("Tabor Facility"); (2) Pennexx's deficient internal financial controls and general inability to accurately report the company's financial condition; and (3) Pennexx's underreporting of its losses for the second quarter of 2002.[7]

1. Tabor Facility

The SAC alleges that Pennexx issued several press releases that misstated or omitted material facts concerning the initial condition of, and the cost of renovations to, Pennexx's Tabor Facility. Lead Plaintiff first challenges Pennexx's February 20, 2002 press release, in which Queen was quoted as stating: "Since

[6] Lead Plaintiff asserts all of its proposed Rule 10b-5 claims against Pennexx, Queen, McGreal, Luter, and Cole. The Court has previously rejected Lead Plaintiff's reliance on the "group pleading" doctrine. See Winer Family Trust, 2004 WL 2203709, at *5-*6. In evaluating each Rule 10b-5 claim, therefore, the Court will only consider the Defendant(s) who personally made or signed the challenged statements.

[7] In its September 27, 2004 Memorandum and Order, the Court dismissed Lead Plaintiff's Rule 10b-5 claims alleging that Pennexx misled the investing public to believe that demand for Pennexx's case-ready meat products was growing during the securities class period. See Winer Family Trust, 2004 WL 2203709, at *22. Lead Plaintiff advised the Court at the October 6, 2004 case management conference that it had new information concerning the falsity of Pennexx's statements about the growing demand for its products. (10/6/04 Tr. at 34-37.) The SAC does not, however, assert any Rule 10b-5 claims based on the growing demand for Pennexx's products.

the new [Tabor] [F]acility requires minimal improvement, we will be able to renovate and automate quickly and plan to be operational in this pristine facility by the second quarter of 2002." (2d Am. Compl. ¶ 52.) Lead Plaintiff asserts that Queen's statement was false and misleading because the Tabor Facility actually required a significant design and construction overhaul requiring a minimum of five months of work conducted by a skilled engineer. Lead Plaintiff previously asserted a Rule 10b-5 claim based on Queen's statements from the February 20, 2002 press release in the FAC. The Court dismissed the claim because Lead Plaintiff had failed to sufficiently allege facts giving rise to a strong inference that Queen acted with scienter in making the challenged statements from the February 20, 2002 press release. See Winer Family Trust, 2004 WL 2203709, at *10. The SAC seeks to cure the deficiencies in the FAC with respect to the challenged statements from the February 20, 2002 press release by alleging new facts based on: (1) the July 20, 2004 deposition testimony of Mike Timmons, a Smithfield engineer and a project leader for the Tabor Facility renovations; (2) Queen's comments during a walking tour of the Tabor Facility on July 23, 2004; and (3) a budget estimate prepared by Robert McClain, a Smithfield engineer and a project leader for the Tabor Facility renovations.

During his July 20, 2004 deposition, Timmons testified that the Tabor Facility was in "relatively poor shape" when he began

working on the project in March 2002. (2d Am. Compl. ¶ 54(i).) Timmons explained that the Tabor Facility "needed a lot of work to bring it up to food safety standards" and that "[t]here was no refrigeration [in the Tabor Facility] that was functional." (Id. ¶ 54(ii).) Timmons also testified that the Tabor Facility's roof, lighting, floors and floor drains were in poor shape, and that Pennexx "never would be able to run the facility" without substantial renovations. (Id.)

During the July 23, 2004 walking tour of the Tabor Facility, Queen remarked as follows:

> One of the major issues in the plant that started to happen right away was that the floor was coming up. We had a brand new floor put down. [It] [w]as very important from a U.S. Government standpoint that no water lies on the floor. Stagnant water is not acceptable to the Government. As you can see here the floor is cracked and coming up and there's stagnant water in several places . . .
>
> The biggest problem we had in th[e] [cooler] area was the lighting. We had asked several times. The lighting has been replaced in here since then but it was so dark in here that it was actually a hazard, that you couldn't even see putting boxes away . . . It created a two-fold problem. One, on a safety issue for the employees but it also, people couldn't actually see what was in the boxes they were picking and that causes a big problem . . ."

(Id. ¶ 54(iii).)

The SAC further alleges that, on March 1, 2002 at 5:46 AM, McClain sent the following e-mail to Dan Stevens, Smithfield's

Chief Financial Officer, and Bob Urell, Smithfield's Vice President: "I have been unsuccessful in reaching Mike Queen this morning. I will continue to try. However, I am attaching a summary of the cost build-up [for the Tabor Facility] based on the information currently in hand. Please call me if you have any questions." (McClain E-mail of Mar. 1, 2002.) The attached budget estimate, which is dated January 29, 2002, states that renovations to the Tabor Facility would cost $4.2 million and that the entire Tabor Facility project would cost $18.6 million to $23.8 million. (McClain Estimate at 1-2.) The budget estimate lists Stevens, Urell, and Queen as recipients. (Id. at 1.)

The Court notes that Timmons did not begin working at the Tabor Facility until March 2002, weeks after Queen made the challenged statements in the February 20, 2002 press release. The SAC does not, in any event, allege that Timmons ever informed Queen of his belief that the Tabor Facility was in poor condition and in need of substantial renovations. At best, therefore, Timmons' testimony merely provides circumstantial evidence that the Tabor Facility was, in fact, in poor condition and needed substantial renovations as of, and likely well before, February 20, 2002. Mr. Timmons deposition testimony does not, however, give rise to a strong inference that Queen acted with scienter in making the challenged statements from the February 20, 2002 press release. See In re Advanta, 180 F.3d at 539 (noting that "general

imputations of knowledge" fail to satisfy scienter requirement).

Queen's admissions during the July 23, 2004 tour concerning the poor quality of the floors and lighting at the Tabor Facility also fail to support a strong inference scienter. Although "a complaint can establish that a statement was false when made by alleging a later statement by defendant along the lines of 'I knew it all along,'" Yourish v. Cal. Amplifier, 191 F.3d 983, 996 (9th Cir. 1999) (internal quotation omitted), Queen's post-class period admissions in this case do not establish that he was aware of the poor condition of the Tabor Facility as of February 20, 2002. Queen's post-class period admissions relate to problems that were identified after the renovations to the Tabor Facility began in May 2002, (2d Am. Compl. ¶ 64), or after Pennexx moved into the Tabor Facility in July 2002. (Id. ¶ 83-84.) For example, Queen remarked during the July 23, 2004 walking tour of the Tabor Facility that Pennexx "had a brand new floor put down" and that "as you can see the floor is cracked and coming up and there's stagnant water in several places." (Id. ¶ 54(iii).) Queen also commented that the Tabor Facility's lighting problems created "a safety issue for the employees" and "people couldn't actually see what was in the boxes they were picking." (Id.)

Queen's knowledge of the January 29, 2002 budget estimate[8]

[8] Although McClain's report is dated January 29, 2002, the version of the report cited in the SAC was not circulated until March 1, 2002, over one week after Queen made the challenged

prepared by McClain also fails to support a strong inference of scienter when considered in context. Queen made the challenged statements in a press release announcing that Pennexx had entered into a preliminary agreement to purchase the Tabor Facility, which the press release described as "a 145,000 square foot facility on 10 acres of land in Philadelphia, Pennsylvania." (Id. ¶ 52.) The February 20, 2002 press release also noted that "[t]he company anticipates that the [Tabor Facility] transaction will close within the next 30 days." (Id.) On March 29, 2002, prior to the closing of the Tabor Facility transaction, Pennexx estimated in its Form 10-KSB for the 2001 fiscal year that renovations to the Tabor Facility would cost $2.0 to $3.0 million and that the total project would cost $10.5 million to $15.0 million. (Pennexx Form 10-KSB at 17, filed Mar. 29, 2002.) Pennexx subsequently filed a Form 8-K in which the company announced that it had finalized the Tabor Facility purchase for $2 million on April 2, 2002. (Pennexx Form 8-K at 1, filed Apr. 17, 2002.)

Queen's February 20, 2002 statements were made, therefore, in the nascent stages of a complex, evolving real estate transaction.

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statements from the February 20, 2002 press release. Moreover, the version of the report cited in the SAC was "based on the information currently in hand" as of March 1, 2002. (McClain Email of Mar. 1, 2002.) Nevertheless, the Court will assume that, as of February 20, 2002, Queen had received a copy of an earlier version of McClain's report and that the cost estimates contained therein were at least comparable to the cost estimates contained in the copy of McClain's report that was circulated on March 1, 2002.

Within weeks of announcing its decision to enter into an agreement to purchase the Tabor Facility and before the acquisition was finalized, Pennexx released preliminary estimates that sufficiently conveyed to the market that purchasing, renovating, and equipping the new facility would require the company to expend substantial capital resources. Under these circumstances, the Court cannot conclude that Queen's knowledge of the January 29, 2002 report prepared by McClain "compels or forcefully suggests" that he acted with scienter in making the challenged statements from the February 20, 2002 press release. At best, Queen's premature optimism amounts to inactionable negligence. See, e.g., Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124, 1129 (2d Cir. 1994) (noting that "misguided optimism is not a cause of action, and does not support an inference of fraud"). The Court concludes, therefore, that the collective allegations of the SAC are insufficient to give rise to a strong inference that Queen acted with scienter in making the challenged statements from the February 20, 2002 press release. As granting Lead Plaintiff leave to amend with respect to this claim would be futile, the instant Motion is denied in this respect.

The SAC also alleges that Pennexx materially understated the cost of the Tabor Facility project in its March 29, 2002 and April 17, 2002 SEC filings. Pennexx's Form 10-KSB for the 2001 fiscal year, which was filed on March 29, 2002, contained the following

"preliminary estimate" of the cost of purchasing, renovating, and equipping the Tabor Facility:

Purchase Price	$2.0 million
Renovation Cost	$2.0 million to $3.0 million
Equipment Costs	$6.5 million to $10.0 million
Total	$10.5 million to $15.0 million

(Pennexx Form 10-KSB at 17, filed Mar. 29, 2002.) The Form 10-KSB was signed by Queen, McGreal, Luter, Cole, and C. Brent Moran, who also served as a director of Pennexx. (Id. at 21.) On April 17, 2002, Pennexx filed a Form 8-K in which the company reiterated its previous estimate that the Tabor Facility's renovations would cost $2.0 million to $3.0 million. (Pennnexx Form 8-K at 1, filed Apr. 17, 2002.) Lead Plaintiff asserts that Defendants knew that the cost estimates contained in the March 29, 2002 and April 17, 2002 SEC filings were false and misleading based on McClain's determination, in his January 29, 2002 budget estimate, that renovations to the Tabor Facility would cost $4.2 million and that the entire project would cost $ 18.6 million to $23.8 million.

Even assuming that Pennexx adopted the cost estimates contained in McClain's report, the Court notes that McClain's report was "based on the information currently in hand" as of March 1, 2002, only nine days after Pennexx had entered into a preliminary agreement to purchase the Tabor Facility and over one month before the acquisition of the Tabor Facility was finalized. The most plausible inference from the allegations of the SAC is

that Pennexx revised its cost estimates in response to ongoing financial negotiations during the intervening time period. Indeed, Pennexx advised the market in the March 29, 2002 Form 10-KSB that "Smithfield has agreed to allow the Company to purchase, renovate, and equip the [Tabor] [F]acility with borrowings under its existing $30 million credit line of up to $2 million, $2 million, and $6.5 million, respectively. If the actual costs exceed these amounts, Pennexx will have to fund the difference from cash flow or will need to obtain additional financing." (Pennexx Form 10-KSB at 17, filed Mar. 29, 2002.)[9] The low-end cost estimates contained in the challenged SEC filings correspond to the limited principal advances permitted by Smithfield under the parties' credit agreement. Mr. McClain's higher cost estimates, by contrast, do not appear to consider the significant constraints on Pennexx's ability to finance the Tabor Facility project. The Court concludes, therefore, that the collective allegations of the SAC fail to give rise to a strong inference that any of the Defendants acted with scienter in issuing the challenged cost estimates in the March 29, 2002 and April 17, 2002 SEC filings. As granting Lead Plaintiff leave to amend with respect to these claims would be futile, the instant Motion is denied in this respect.

[9] The April 17, 2002 Form 8-K contains a materially identical statement. (See Pennexx Form 8-K at 1, filed Apr. 17, 2002.)

2. Pennexx's reporting of financial information[10]

Lead Plaintiff asserts that Defendants recklessly reported Pennexx's financial information in several SEC filings during the class period. Lead Plaintiff specifically challenges the following statement, which appeared in all of the Form 10-QSBs filed by Pennexx during the class period:[11]

> In the opinion of the Company, *all adjustments, including normal recurring adjustments, necessary to present fairly the financial position of the Company* as of [the specified period] and the results of its operations and cash flows for [the specified period] have been included. The results of operations for the interim period are not necessarily indicative of the results for the year.

(2d Am. Compl. ¶ 66) (emphasis added). Lead Plaintiff also challenges the following statement, which appeared in Pennexx's

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[10] Defendants note that Lead Plaintiff has not previously asserted any Rule 10b-5 claims based on Pennexx's reporting of its financial information. At the October 6, 2004 status conference, the Court advised Lead Plaintiff's counsel that "if you're going to expand [the proposed SAC] beyond what was initially in the case I'm telling you I'm going to deny it." (10/6/04 Tr. at 49-50.) However, Lead Plaintiff's new Rule 10b-5 claims based on Pennexx's reporting of its financial condition are sufficiently related to the existing allegations of the FAC. The Court concludes, therefore, that Lead Plaintiff did not act in contravention of the Court's directive in including these claims in the SAC.

[11] Pennexx filed the challenged Form 10-QSBs on April 9, 2002, May 15, 2002, August 19, 2002, and November 14, 2002. The April 9, 2002 Form 10-QSB was signed by Queen and McGreal. The May 15, 2002 Form 10-QSB was signed by Queen and Pearcy. The August 19, 2002 Form 10-QSB was signed by Queen. The November 14, 2002 Form 10-QSB was signed by Queen and Joseph Beltrami, Pennexx's Chief Financial Officer.

April 1, 2003 Form 10-KSB for the 2002 fiscal year:

> The Company carried out an evaluation of the effectiveness of its disclosure controls and procedures within 90 days prior to the filing of this report. This evaluation was carried out under the supervision and with the participation of the Company's management, including the Company's President and Chief Executive Officer and the Chief Financial Officer. Based on that evaluation, the Company's President and Chief Executive Officer and the Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective. There have not been any significant changes in the Company's internal controls, or in other factors which would significantly affect internal controls subsequent to the date the Company carried out its evaluation, or any corrective actions taken with regard to significant deficiencies or material weaknesses.

(Id. ¶ 68.) The April 1, 2003 Form 10-KSB was signed by Queen, McGreal, Beltrami, and Moran. (Id.) Appended to the April 1, 2003 Form 10-KSB were certifications signed by Queen and Beltrami which stated that they had disclosed to Pennexx's "auditors and the audit committee of [Pennexx's] board of directors . . . all significant deficiencies in the design or operation of internal controls which could adversely affect [Pennexx's] ability to record, process, summarize and report financial data and have identified for [Pennexx's] auditors any material weaknesses in internal controls." (Id. ¶ 69.) Lead Plaintiff contends that the challenged statements were false and misleading because Pennexx lacked the internal controls necessary to ever accurately report the company's

financial information to the SEC.

Defendants maintain that Lead Plaintiff's failure to contest a single number contained in the challenged SEC filings is fatal, as claims grounded on corporate mismanagement are not actionable under the federal securities laws. As a general matter, "allegations of failure to disclose mismanagement alone do not state a claim under federal securities law." In re Craftmatic Sec. Litig., 890 F.2d 628, 639 (3d Cir. 1989). Thus, "it is not a violation of the securities laws to simply fail to . . . provide sufficient internal controls." Shapiro v. UJB Fin. Corp., 964 F.2d 272, 283 (3d Cir. 1992). However, "a complaint does allege an actionable misrepresentation if it alleges that a defendant was aware that mismanagement had occurred and made a material public statement about the state of corporate affairs inconsistent with the existence of the mismanagement." Hayes v. Gross, 982 F.2d 104, 106 (3d Cir. 1992). Accordingly, the securities laws are implicated where a company publicly comments on the nature or quality of its management practices. See Shapiro, 964 F.2d at 282 (noting that "where a defendant affirmatively characterizes management practices as 'adequate' . . . and the like, the subject is 'in play' . . . and [the defendant] thus is bound to speak truthfully").

The securities laws are, therefore, implicated in this case because Pennexx made affirmative representations throughout the

class period regarding the effectiveness of the company's financial disclosure controls and the company's concomitant ability to fairly present its financial position. The SAC asserts that the challenged statements were false and misleading and that Defendants acted with scienter in making the challenged statements based on: (1) a memo prepared by Jeffrey Deel, a Smithfield employee, concerning Pennexx's food control weaknesses; (2) a report prepared by Bart Ellis, Smithfield's Vice President of Operations, concerning Pennexx's financial losses and business culture; and (3) admissions made by Queen during the July 23, 2004 walking tour concerning flaws in Pennexx's yield monitoring system.

In an August 2, 2002 memorandum entitled, "Pennexx Report - Financial Losses and Business Culture" (hereinafter, "the Ellis Report"), Ellis summarized the results of an audit and inspection of Pennexx that had been performed by Smithfield. (Ellis Report at 1.) The Ellis Report was sent to Queen, Luter, and other Smithfield and Pennexx executives. (Id.) The Ellis Report noted that Smithfield's audit and inspection of Pennexx was prompted by "inordinate losses" generated by Pennexx in both "the fall of 2001" and the period from "April 2002 to current" without any "advance notification provided by Pennexx management of these developing poor financial losses." (Id.) The Ellis Report commented that "Pennexx executives accept that no timely reporting exists, to the point where an outside observer would reasonably believe that

management is indifferent. Many support functions (HR, I/S, accounting, credit/receivables, payables, maintenance) appear to be of secondary importance to management." (Id.) The Ellis Report found that the following "deficiencies result from this culture":

> A. Financial reporting is lacking as to internal controls (see Deel memo of July 24, 2002) and report production is not performed on schedule. Income statement[s] and balance sheet[s] are only published on a quarterly basis on the schedule demanded by SEC 10Q requirements.
>
> B. The weekly stock ledger report which quantifies product yield, meat cost, and a weekly P/L estimate on a billable basis has not been generated on time back to at least April. The report has been reviewed and it does track with the income statement. Of course, neither the stock ledger or the income statement are produced so that management can schedule formal reviews.

(Id.) The Ellis Report proposed the following as "immediate priorities" for Pennexx:

> A. Monthly financial reports are issued by the 2nd Friday following the month [sic] end, and the actual earnings number is known by mid-afternoon on the 2nd Wednesday.
>
> B. The weekly Stock Ledger report is issued by the end of business each Monday for the prior week.
>
> C. Establish and define and [sic] organization structure which defines duties and responsibilities.
> Accounting should have two groups - Financial (general) and Cost
> Human Resources responsibilities should

> not fall to accounting staff.
> Quality Assurance should answer directly to the president, not operations.

(Id. at 1-2.) The Ellis Report concluded by expressing the following concerns:

> [C]urrent Pennexx management lacks the fundamental business and operating skills which are required to generate consistent positive results on a go forward basis. The start up challenges alone for this expansion will prove formidable for any strong organization. These challenges will prove devastating for the current organization.

(Id. at 2.)

The "Deel memo" referenced in the Ellis Report was prepared for the Pennexx "file" by Smithfield's Jeffrey Deel on July 24, 2002. (Deel Memo at 1.) In the memo, which is entitled "Pennexx Food Control Weaknesses" (hereinafter, "the Deel Memo"), Deel noted several factors that "could generate yield losses" for Pennexx. (Deel Memo at 1.) The Deel Memo noted that Pennexx's "accounting staff is not generating needed production analysis" and recommended that Pennexx "consult with other Smithfield Foods subs or other outside experts in cost accounting to develop accounting and reporting systems to identify and segment responsibility areas of production." (Id.) The Deel Memo also noted that "[i]nventory reconciliations are not performed" by Pennexx and recommended "development of a perpetual inventory system to track SKU's on a daily basis." (Id.) The Deel Memo further noted that Pennexx employees "sometimes" complete purchase orders for raw materials

and supplies "after the fact," but fail "to document the intended agreement." (Id.) Deel recommended that Pennexx employees complete "all [purchase order] info at commitment and set[ ] volume maximums on supply quantities."[12] (Id.)

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[12] The SAC attempts to impute knowledge of the Deel Memo and Ellis Report to McGreal and Cole based on the following allegations:

> (i) The [Ellis] [R]eport indicates that it was circulated to Defendants Queen and Luter IV.
> (ii) That Defendant Luter shared the sentiments expressed in the [Deel] [M]emo and [Ellis] [R]eport of July and August 2002 is evident from his comments at a September 24, 2002 meeting of the Pennexx board of directors (as memorialized in the minutes of the meeting) that "he remained concerned that the 'true financial situation' of the Company might not be known in light of [former Pennexx CFO] George Pearcy['s] allegations" [that Pennexx executives pressured him to underreport the company's net losses for the second quarter of 2002].
> (iii) Mr. Luter IV repeated these concerns at a meeting of the Pennexx board of directors held on September 26, 2004 (as noted in the minutes thereto) when he noted that a letter from Smithfield which stated that Pennexx "may have" breached its loan covenants with Smithfield "reflected a lack of confidence in the true financial picture of the Company after the George Pearcy incident.

(2d Am. Compl. ¶ 79.) These allegations merely establish that Luter discussed Pearcy's allegations at the Pennexx board meetings of September 24, 2002 and September 26, 2002. In the absence of specific allegations that Luter discussed the Deel Memo and the Ellis Report at Pennexx board meetings, Lead Plaintiff cannot impute knowledge of the Deel Memo and the Ellis Report to McGreal and Cole. Furthermore, to the extent that Lead Plaintiff also relies on these allegations in pleading material misstatements and scienter, the Court finds that Luter's "concerns" about the Pearcy allegations fail to establish that any of the challenged statements alleged in the SAC, including Pennexx's statement of its net losses

The SAC further alleges that, during the July 23, 2004 walking tour of the Tabor Facility, Queen admitted that the production analysis necessary to timely monitor Pennexx's results was non-existent:

> There's no way in this system [i.e., the Tabor Facility's yield monitoring system] to tell you what's in your finished goods inventory, which also gives you a weight. That weight is your final yield. Because that information was so flawed and not having that to know what our weight was, we had to wait until our monthly P&Ls were completed before we knew what our yield loss was because the system was never up and running in getting us timely yields as we needed them and as it was designed. So we were basically relying on an accounting system which was a Quick Books accounting system, so a monthly inventory at the end of the month to find out where you were and it was usually takes us ninety days to complete to know where we were the previous month. So as we started doing more business and we did a lot of business in the month of February [2003], when we got our inventory back, we had lost $400,000 in yield loss and had absolutely no idea where or why we had lost that money. And the system was all designed to tell us specifically where it went but it didn't because it didn't function properly . . . .
>
> . . . You cannot run a plant that does not give you on-line yielding.

(2d Am. Compl. ¶ 80.)

Lead Plaintiff asserts that the allegations in the SAC collectively demonstrate that Defendants, while conscious of

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for the second quarter of 2002, were false or misleading when made or that Defendants acted scienter in making the challenged statements.

Pennexx's deficient internal controls, recklessly made false statements concerning the effectiveness of the company's financial disclosure controls and the company's concomitant ability to accurately disclose its financial information. As an initial matter, the Court notes that Queen's comments during the July 23, 2004 walking tour fail to establish the falsity of Defendants' statements concerning Pennexx's ability to generate accurate financial information. Queen's comments merely reveal that Pennexx's yield monitoring system failed to provide accurate, realtime inventory data, and that, as a result, the company was not aware of the magnitude of its yield losses until the monthly accounting results were subsequently released. Queen does not suggest that the flaws in Pennexx's yield monitoring system prevented the company from accurately disclosing its financial condition to the SEC.

The Court further concludes that neither the Ellis Report nor the Deel Memo demonstrate that the challenged statements concerning Pennexx's ability to generate accurate financial information were false or misleading. The Ellis Report only criticizes the timeliness of Pennexx's financial reporting, not the accuracy of Pennexx's financial reporting. Cf. In re IKON Office Solutions, Inc. Sec. Litig., 66 F. Supp. 2d 622, 631 (E.D. Pa. 1999) (holding that plaintiff sufficiently alleged misstatement where plaintiffs identified internal memoranda and an audit that raised "numerous

red flags evidencing that the Company's internal controls were gross deficient and *that the financial data being generated by its financial reporting mechanism was so pervasively inaccurate and unreliable that reliance on that information for financial statement purposes was precluded by GAAP and GAAS*") (emphasis added). Moreover, it appears that the Ellis Report refers only to Pennexx's failure to provide Smithfield, and not the SEC, with timely financial information, as the report indicates that Pennexx's "income statement[s] and balance sheet[s] are only published on a quarterly basis on the schedule demanded by SEC 10Q requirements." (Ellis Report at 1.) Although the Ellis Report cites the Deel Memo for the proposition that Pennexx's "financial reporting is lacking as to internal controls," the Deel Memo neither states nor implies that Pennexx lacked the internal controls necessary to accurately disclose the company's financial condition to the SEC. The Deel memo instead focuses on ways in which Pennexx could improve its production efficiencies to minimize yield losses. In the absence of any specific allegations that Pennexx's internal controls and procedures for disclosing financial information to the SEC were ineffective, the court cannot infer that Defendants acted negligently, much less with scienter, in making the challenged statements.

Even if the deficiencies in Pennexx's internal controls identified in the Deel Memo and the Ellis Report did implicate the

company's ability to accurately disclose its financial information, Lead Plaintiff has still failed to sufficiently allege facts that give rise to a strong inference that Defendants acted with scienter in making the challenged statements. The April 9, 2002 and May 15, 2002 Form 10-QSBs were issued prior to the dissemination of the Deel Memo and the Ellis Report. There are no other allegations in the SAC from which the Court could infer that Defendants acted with scienter in making the challenged statements in the April 9, 2002 and May 15, 2002 SEC filings. See Abrams v. Baker Hughes Inc., 292 F.3d 424, 433 (5th Cir. 2002) ("The fact that [defendant] was overhauling its accounting system . . . does not command an inference that company officials should have anticipated finding a problem or that financial data reported under the old system was inaccurate."); In re Sunterra Corp. Sec. Litig., 199 F. Supp. 2d 1308, 1326 (M.D. Fla. 2002) (concluding that allegations regarding "the breakdown in the internal controls and the review thereof" only established negligence of defendants); Wilson v. Bernstock, 195 F. Supp. 2d 619, 639-40 (D.N.J. 2002) (dismissing securities claim where plaintiffs failed to allege contemporaneous facts that defendants knew trade management computer system was unable to properly capture and analyze trade marketing information, even though "Defendants concede[d] that, in retrospect, the defects in the [computer system] were material insofar as correction of these problems eventually revealed a much larger outstanding consumer

deduction balance than the company had estimated in its financial reports"); In re Westinghouse Sec. Litig., 832 F. Supp. 948, 979 (W.D. Pa. 1993) ("Plaintiffs may not cite confidential communications, policy recommendations and internal memoranda identifying measures by which Westinghouse could improve some areas of operations and allege that the corporation had previously committed fraud."), aff'd in part, rev'd in part, 90 F.3d 696 (3d Cir. 1996).[13]

Furthermore, the SAC is devoid of allegations that Defendants consciously or recklessly opted not to improve the company's financial disclosure controls and procedures in response to the observations and recommendations made in the Ellis Report and Deel Memo. See Svezzese v. Duratek Inc., Civ. A. No. 01-1830, 2002 WL 1012967, at *5 (D. Md. Apr. 30, 2002) (distinguishing cases that "contain allegations of *pervasive, ongoing* deficiencies in the internal controls that were *known* to the defendant companies") (emphasis added), aff'd, 67 Fed. Appx. 169 (4th Cir. 2003) (unpublished decision); cf. In re IKON, 66 F. Supp. 2d at 631 (holding that plaintiffs adequately alleged scienter by describing "a variety of internal memoranda expressing concern that the problems had not been corrected"); In re Westinghouse, 832 F. Supp.

[13] In In re Westinghouse Sec. Litig., 90 F.3d 696 (3d Cir. 1996), the Third Circuit affirmed the district court's dismissal of the plaintiffs' Rule 10b-5 claim alleging that the defendant-company misrepresented the adequacy of its internal controls. Id. at 711-12.

at 979 (noting the Section 10(b) of the Exchange Act "may not be used to punish [companies] for identifying and implementing improvements to corporate policies").[14]

The Court concludes, therefore, that the collective allegations of the SAC fail to sufficiently allege that the challenged statements were false or misleading when made, or that Defendants acted with scienter in making the challenged statements. As granting Lead Plaintiff leave to amend with respect to these claims would be futile, the instant Motion is denied in this respect.

3. Underreporting of Losses

The SAC alleges that Pennexx underreported the company's losses for the second quarter of 2002. On August 19, 2002, Pennexx disclosed in its Form 10-QSB that the company had suffered a net loss of approximately $2.2 million for the second quarter of 2002.

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[14] In support of the scienter element, the SAC also alleges that Pennexx's reported financial information violated generally accepted accounting principles ("GAAP"). The GAAP violations alleged in the SAC are, however, based entirely on the Ellis Report, the Deel Memo, and Queen's admissions during the July 23, 2004 walking tour concerning flaws in Pennexx's yield monitoring system. See Holmes v. Baker, 166 F. Supp. 2d 1362, 1379 (S.D. Fla. 2001) (noting that while GAAP violations, combined with other "red flags," may establish scienter, the purported "red flags cannot consist primarily of rehashes of the GAAP violations"). Moreover, the SAC does not allege that Defendants knew that Pennexx's reported financial information violated GAAP. See In re AFC Enterprises, Inc. Sec. Litig., Civ. A. No. 03-817, 2004 WL 2988212, at *8 (N.D. Ga. Dec. 28, 2004) ("It is . . . tenuous to impute knowledge of cumulative accounting errors generally to operational officers and directors of a corporation.").

(Pennexx Form 10-QSB at 3, filed Aug. 19, 2002) The Form 10-Q was signed by Queen. (Id. at 14.) Pennexx reiterated the $2.2 million figure in a press release issued on August 20, 2002. (2d Am. Compl. ¶ 96.) In the FAC, Lead Plaintiff asserted that Pennexx fraudulently underreported its losses for the second quarter of 2002 based on Pearcy's preliminary determination that the company suffered net losses of $2.5 million.[15] Winer Family Trust, 2004 WL 2203709, at *19. The Court dismissed this claim because, even assuming that the alleged misstatement of losses was material, Lead Plaintiff had failed to sufficiently allege facts giving rise to a strong inference that Defendants acted with scienter in reporting Pennexx's losses for the second quarter of 2002. Id. The Court

[15] The SAC reiterates the following allegations from the FAC in support of the instant claim. On numerous occasions, Pearcy was informed by Queen and other Pennexx officers, including Dennis Bland, Pennexx's Chief Operating Officer, and McGreal, that he was permitted to report losses in the range of $800,000 to $ 1.2 million for the second quarter of 2002, but in no event was he to report losses in excess of $1.2 million. (2d Am. Compl. ¶ 87(a).) In anticipation of filing Pennexx's Form 10-QSB on August 14, 2002, Pennexx held a meeting during which Pearcy advised other Pennexx officers that he intended to disclose that Pennexx had suffered losses of $ 2.5 million for the second quarter of 2002. (Id. ¶ 87(b).) Queen refused to accept the loss and left the meeting. (Id. ¶ 87(c).) On August 12, 2002, Queen, McGreal, and Bland handed Pearcy a two-page letter which purported to terminate him for incompetence. (Id. ¶ 87(e).) On August 13, 2002, Pearcy met with an ad hoc audit committee of Pennexx and told them that the preliminary financial results showed a quarterly loss of approximately $2.5 million and that he had been directed by management to report a loss of no greater than $800,000 to $1.2 million. (Id. ¶ 87(f).) Pearcy's allegations were subsequently reviewed by both Pennexx's outside auditor and Smithfield's outside auditor. (Id. ¶ 88.)

noted that Lead Plaintiff did not allege that any of the Defendants ever adopted Pearcy's loss determination. Id. The Court further found that "the more compelling inference from the facts alleged in the Amended Complaint is that the $2.2 million loss reported in the SEC filings was based on the outside auditors' review of Pennexx's financials." Id. The SAC seeks to cure the deficiencies identified by the Court by alleging new facts based on the Deel Memo, the Ellis Report, and Queen's admissions during the July 23, 2004 walking tour.

The internal controls allegations based on the Deel Memo, the Ellis Report, and Queen's admissions during the July 23, 2004 walking tour fail give rise a strong inference that Queen and Pennexx acted with scienter in making the challenged statements. As discussed above, the internal controls allegations in the SAC do not implicate the accuracy of Pennexx's financial disclosures. Even if the internal controls allegations in the SAC did implicate the accuracy of Pennexx's financial disclosures, the Court notes that "[i]nternal controls allegations are frequently dismissed, even when a corporation's executives knew that the internal controls were inadequate." Crowell v. Ionics, Inc., 343 F. Supp. 2d 1, 19-20 & n.12 (D. Mass. 2004) (citing cases); see also Svezzese, 2004 WL 1012967, at *6 (noting that most colorable securities claims involving the misstatement of specific financial data based on deficient internal controls "include other

allegations which strongly give rise to an inference of scienter on their own, such as insider trading").

In Crowell, the securities plaintiff argued, *inter alia*, that the defendant corporation knowingly overstated its revenues by tens of millions of dollars. 343 F. Supp. 2d at 9. In support of his claim, plaintiff alleged that defendant's system of internal controls was materially deficient. Id. at 19. The court observed that the "[f]acts alleged in [plaintiff's] complaint suggest that [defendant's] failure to develop internal controls was egregious" and that "a better formula for systematic revenue misstatement would be difficult to imagine." Id. at 20. Notwithstanding the egregious deficiencies in the defendant's internal financial controls, the Court noted that "[i]f the allegations regarding [defendant's] failure to maintain adequate internal controls were the only ones in the Complaint, the Court would almost certainly have to dismiss the case," as "standing alone, even this level of mismanagement does not constitute scienter." Id. at 19-20. However, as the plaintiff had also "adequately alleged that [defendant] engaged in multiple courses of conduct to inflate revenues artificially," the Court concluded that "the desire to hide such fraudulent conduct would provide an obvious motive to maintain minimal internal controls." Id. Thus, "when considered in context with the other, stronger allegations, [plaintiff's internal controls allegations] at least strengthen[] [plaintiff's]

case." Id.

In this case, by contrast, the facts alleged in the SAC do not support any inference that Pennexx consciously maintained minimal internal controls in order to conceal a fraudulent course of conduct. Pearcy's $2.5 million calculation was allegedly based on "preliminary" financial results, which were subsequently reviewed by an ad hoc audit committee appointed by Pennexx, as well as the outside auditors for both Pennexx and Smithfield. Although Pennexx executives allegedly pressured Pearcy not to report losses in excess of $1.2 million, the company ultimately reported significantly greater losses of $2.2 million, which was only $300,000 less than Pearcy's "preliminary" determination. Accordingly, the Court concludes that the collective allegations of the SAC fail to give to rise to a strong inference that Queen and Pennexx acted with scienter in reporting the company's financial losses for the second quarter of 2002. As granting Lead Plaintiff leave to amend with respect to this claim would be futile, the instant Motion is denied in this respect.[16]

C. Sanctions

The Smithfield Defendants request that the Court require Lead Plaintiff to reimburse them for the costs of responding to the instant Motion. The Smithfield Defendants maintain that sanctions

[16] Lead Plaintiff concedes the remaining press releases cited in the SAC do not allege false or misleading misstatements under Rule 10b-5. (Pl.'s Reply at 13-14.)

are warranted in this case based on Lead Plaintiff's "deliberate disregard of this Court's instruction not to add new allegations to the Proposed Complaint" and Lead Plaintiff's "blatant mischaracterization of the relevant documents." (Smithfield Defs.' Mem. at 24.)

Section 78u-4(c)(1) of the PSLRA provides that: "In any private action arising under this chapter, upon final adjudication of the action, the court shall include in the record specific findings regarding compliance by each party and each attorney representing each party with the requirements of Rule 11(b) of the Federal Rules of Civil Procedure as to any complaint, responsive pleading, or dispositive motion." 15 U.S.C. § 78u-4(c)(1). As this action has not yet been finally adjudicated, it would be premature for the Court to perform the inquiry mandated by § 78u-4(c)(1) at this juncture. Moreover, the Smithfield Defendants have not independently moved for sanctions pursuant to Federal Rule of Civil Procedure 11. Accordingly, the Court declines to entertain the Smithfield Defendants' request for sanctions.

IV. CONCLUSION

For the foregoing reasons, Lead Plaintiff's Motion for Leave to Amend and File a Second Amended Complaint is denied in its entirety.

An appropriate Order follows.

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

THE WINER FAMILY TRUST	:	CIVIL ACTION
	:	
	:	
v.	:	
	:	
	:	
MICHAEL QUEEN, et al.	:	NO. 03-4318

O R D E R

AND NOW, this 13th day of January, 2005, upon consideration of Lead Plaintiff's Motion for Leave to Amend and File a Second Amended Complaint (Doc. No. 87), the Smithfield Defendants' Response thereto (Doc. No. 90), the Pennexx Defendants' Response thereto (Doc. No. 91), and all attendant and responsive briefing, **IT IS HEREBY ORDERED** that said Motion is **DENIED** in its entirety.

BY THE COURT:

s/ John R. Padova
John R. Padova, J.